IN THE

Supreme Court of the United States

OCTOBER TERM, 1944.

Nos. 739-740

INTERNATIONAL STANDARD ELECTRIC CORPORATION,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

ALLIN H. PIERCE,
Counsel for the Petitioner.

THE COURT PRESS, N. Y. C.

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v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

International Standard Electric Corporation, the petitioner above named, prays that writs of certiorari issue to review the judgments of the United States Circuit Court of Appeals for the Second Circuit entered in the above-entitled cases on September 9, 1944 (R. 102, 104), affirming in part the decisions of The Tax Court of the United States (R. 55).

OPINIONS BELOW.

The opinion of the Tax Court (R. 42-54), which covers both of the cases involved, is reported in 1 T. C. 1153.

The opinion of the Circuit Court of Appeals for the Second Circuit (R. 95-101), which likewise covers both cases, is reported in 144 F. 2d 487.

Jurisdiction.

The judgments of the Circuit Court of Appeals were entered on September 9, 1944 (R. 102, 104). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Question Presented.

The issue relates to the credits allowable against United States income taxes, under Section 131 of the Revenue Acts of 1936 and 1938, for taxes paid or accrued to foreign countries.

The sole question presented is whether the applicable statutes compel the invalidation, retroactively, of provisions of treasury regulations and official forms which, for more than twelve years, have specified the method for calculating foreign tax credits and have required taxpayers to employ such method as a condition to allowance of the credits.

Petitioner contends that the regulations and official forms, upon which both the Government and it relied during the taxable years, should be sustained. The Court below rejected this contention, with the following statement (R. 100):

> "It is because of the clear terms of the statute that it is impossible for us to sustain contentions of the taxpayer based upon administrative procedure in prior years and some indications in Treasury Form 1118 which seem to bear a contrary interpretation of the meaning of the statute."

Statutes, Regulations and Treasury Form Involved.

The statutes, regulations and treasury form involved are set forth in the Appendix, *infra*.

Statement of Matter Involved.

These cases involve deficiencies in income taxes and excess-profits taxes determined against the petitioner for the calendar years 1937 and 1938, respectively. Both involve the same issue which, as stated above, pertains to the credit for foreign taxes allowable under Section 131 of the Revenue Acts of 1936 and 1938. The cases were consolidated below (R. 89), although separate judgments were entered; and they come before this Court on a consolidated record.

The cases appear to be test cases in which the respondent is attempting to establish, through judicial decision rather than by legislative action, a new method for computing foreign tax credits, which is contrary to the method of computation which the Treasury, for more than twelve years, has uniformly prescribed in its regulations and official forms, including those now in force.[1]

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[1] Article 131-3 of the Regulations (*infra*, p. 19) provides that every corporation must, as "Conditions of Allowance of Credit," attach Form 1118 to its income tax return and, under oath, supply "the information there called for" and make "the calculations of credits there indicated."

Form 1118 (*infra*, p. 22) shows that, for each foreign country in respect of which credit is claimed, "Income * * * exclusive of dividends received" and "Dividends received" are to be treated separately; and that the full amount of "Dividends received" is to be included in the "Total income" which is used in computing the foreign tax credit.

Article 131-8 of the Regulations (*infra*, p. 19) employs examples to illustrate "the operation of the limitations on the credit for foreign taxes"; and Example (3) thereof shows that,

[Footnote continued on following page.]

Under this prescribed method of computation, dividends from foreign corporations are separated from the other classes of foreign income; and, unlike such other classes, the full amount of "Dividends received" is included in the total *net* income from foreign sources, without deduction of any expenses. Such treatment apparently is based upon the principle that foreign dividends are earned and distributed at the expense of the foreign corporation alone, and that no expenses of the domestic stockholder are attributable to them.

Under the method of computation for which the respondent now contends, the distinction between "Income * * * exclusive of dividends received" (business income) and "Dividends received" (investment income) is wiped out; both classes of income are commingled, apparently in direct violation of the requirements of the above-mentioned regulations and official forms of the Treasury; and consequently, dividends received from foreign corporations are charged with an allocated portion of the taxpayer's expenses. The effect is that there is not a true reflection of net income by countries, for, where

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[Footnote continued from preceding page.]

where a domestic corporation received income from France which was derived partly from "dividends" and partly from "branch operations," the dividends should be treated separately, and the full amount thereof should be included as an item of the "Total foreign net income" used to compute the credit.

The above-described provisions of the Regulations were included in Articles 693 and 698 of Regulations 77(1932); and they were thereafter repromulgated without material change in Articles 131-3 and 131-8 of Regulations 86(1934), 94(1936), 101(1938), 103(1940) and 111(1943).

Form 1118 has been reissued annually since 1932 without material change, except that since 1942 the more exact terms "Net income * * * exclusive of dividends received" and "Total net income" have been employed. This further emphasizes the fact that the full amount of "Dividends received" is to be regarded as a "net" figure.

investment income is derived from one foreign country and business income is derived from another, the net income from the first country is reduced by expenses which have no relation to the production of the dividends, while the net income from the other country is overstated through failure to deduct all expenses attributable to the production of the business income. Such method also affects the amount of the taxpayer's allowable credit by attributing to certain countries less credit than can be used, and by attributing to other countries increased credit which cannot be used because in excess of the foreign tax paid. In the instant case, application of this revised method of computation caused a major part of petitioner's expenses to be apportioned against dividends distributed to it by foreign corporations[2] and resulted in the assertion of a substantial deficiency in tax for each of the years involved (R. 11-13, 31-33).

The respondent's revised method of computation did not result from any change in the controlling statutes or regulations, for these have not been materially changed since 1932. As regards petitioner, the new method was first invoked in 1941 on the audit of petitioner's 1937 and 1938 income taxes, after its 1935 and 1936 taxes had

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[2] Petitioner's business income for the years involved consisted principally of profits from export sales, royalties from patents, fees under contracts to provide management services, and interest (R. 44-45).

Its investment income for said years consisted of dividends accrued from 18 corporations in 1937 and from 17 corporations in 1938 (Physical Exhibits 1 and 2, Sched. 2). The corporate stocks upon which these dividends were distributed had been owned by petitioner for many years and were not traded in but were held passively (R. 47, 75, 77, 82); and an officer of petitioner testified that the dividends therefrom flowed to petitioner without any expense on its part (R. 81-82, 85-86).

Computations made by the petitioner indicate that the amounts of petitioner's expenses apportioned to foreign dividends, under respondent's revised method of computation, were $747,272.25 for the year 1937 and $1,181,187.63 for the year 1938.

been finally adjusted through application of the prior method and also after its 1937 tax had been adjusted through application of that method in two previous audits which petitioner had accepted (Physical Exhibits 3; 4; 5, p. 1; 6, pp. 2-3). Only one other decided case has been found in which this new method of computation has been applied; and that involved taxable years subsequent to those here involved and was decided by the Tax Court on authority of the instant case (*South Porto Rico Sugar Co.*, 2 T. C. 738 (1943)).

The respondent's position appears to be that the method for computing foreign tax credits prescribed in the above-mentioned regulations and official forms, should not be given effect.[3] He contends that determination of the amount of income derived from each foreign country is controlled by Clause (1) of Section 131(e) of the statutes which make reference to Section 119; and that the determination of such amount is not controlled by Clause (2) of Section 131(e), which states expressly: "Such amount to be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary,". The respondent further contends that, upon application of Section 119(d), the major part of the expenses of petitioner must be allocated against the dividends received from foreign corporations, which were earned, distributed, and taxed at source abroad before they were includible in petitioner's income.

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[3] The respondent in his brief for the Circuit Court of Appeals said (pp. 14-15):

> "The example [Example (3) in Art. 131-8, Regs. 94 and 101] lends some support to the taxpayer's contention * * *."
>
> "Treasury Form 1118 tends to support the taxpayer's position in that it separately calls for net income exclusive of dividends received, and the amount of dividends received. * * * Matter contained in a form cannot constitute a binding administrative construction. * * * And in no case may the form and the example in Art. 131-8 be given effect contrary to the plain meaning of the statute."

The petitioner's position, on the other hand, is that respondent's newly adopted construction of Section 131(e) and also his construction of Section 119(d), both of which he must sustain to support the deficiencies here involved, are erroneous; and that neither of these sections requires disregard or invalidation of the long-established administrative practice. Petitioner contends, first, that respondent's construction of Section 131(e) would make the second clause of that section redundant and ineffective; but that both clauses of the section can be given effect and the long established administrative practice can be sustained, if Clause (1) is construed to employ Section 119 for the purpose of classifying income as to "sources" (from within or from without the United States), and if Clause (2) is construed to give the Treasury power to prescribe, through its rules and regulations, the methods and details of computing "the amount of income derived from each country".

Secondly, the petitioner contends that, even if Section 119 does control the determination of the amounts of income by countries, the method of computation prescribed in the regulations and in Treasury Form 1118 still should be sustained. Section 119(d) (*infra*, p. 17) requires, in substance, that the expenses of the taxpayer must, if possible, be allocated directly to the particular items and particular classes of income to which they pertain; that if such direct allocations cannot be made, the expenses must be ratably apportioned among those particular classes of income to which they are attributable; and that only as a last resort may an arbitrary apportionment be made ratably against income of all classes.

The Tax Court sustained the respondent's contentions (R. 49-52) without making any reference whatever to the established administrative practice or to the above-men-

tioned regulations and official forms of the Treasury Department; also, in connection with its holding on this point, it cited no judicial authority except a comparative reference to *Third Scottish American Trust Co., Ltd.* v. *United States*, 37 F. Supp. 279 (Ct. of Cls.—1941), which did not involve either a domestic corporation or the calculation of foreign tax credits.

The Circuit Court of Appeals affirmed the Tax Court's decision, but indicated reluctance to overrule the established administrative practice. The Court cited no judicial authority and did not refer to the regulations. It did modify the Tax Court's decision by holding that royalty expenses which could not be allocated directly must be apportioned ratably against income produced by the royalty expense; but it failed to apply this principle to the greater part of petitioner's expenses, and to apportion them ratably against all business income as a class, rather than against both business income and investment income.

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

1. In failing to give effect to the requirements of regulations and official forms of the Treasury Department, which have been in effect for many years and upon which both the Government and the petitioner relied during the taxable years involved.

2. In holding that Section 131(c) of the applicable statutes requires the amount of income derived from each foreign country to be determined under Section 119 of

the statutes, rather than under "rules and regulations prescribed by the Commissioner with the approval of the Secretary".

3. In failing to hold that, even if Section 119 controls the determination of income by countries, business expenses must, in accordance with the requirements of the regulations and official forms of the Treasury, be allocated or apportioned only to items and classes of business income, and not to investment income to which they are not attributable.

Reasons for Granting the Writs.

I.

The Circuit Court of Appeals has decided an important question of Federal law which has not been, but should be, settled by this Court.

The decisions below defeat, in a large measure, the intention of Congress to prevent international double taxation. All revenue acts in force since the enactment of the Revenue Act of 1918 have permitted taxpayers to claim credit against their United States income taxes for income, war profits, and excess-profits taxes paid to foreign countries. (Rev. Acts 1918, 1921, 1924, and 1926, Secs. 222, 238; Rev. Acts 1928, 1932, 1934, 1936, 1938 and I. R. C., Sec. 131.) The purpose of Congress in providing such credits was to encourage foreign commerce and facilitate foreign enterprise by mitigating the evil of double taxation that arises when each of two sovereignties imposes tax upon the same income, one sovereignty having jurisdiction over the person of the taxpayer and

the other having jurisdiction over the income at its source. *Burnet* v. *Chicago Portrait Co.*, 285 U. S. 1, 9 (1932); Ways and Means Committee Report on the 1918 Revenue Bill, 65th Cong., 2d Sess., H. Rept. 767, p. 11.

Under the 1918 Act, the amount of credit allowable was the full amount of foreign tax paid; but under subsequent Acts a limitation has been imposed upon the amount of credit allowable, in order to prevent the United States tax being excessively reduced in situations where high foreign tax rates might create a larger credit than is necessary to prevent double taxation. (See Section 131(b), *infra*, p. 18). The scheme of these limitation provisions is, in effect, to determine what part of the United States tax has been imposed on the income received from a particular foreign country, by observing the ratio of the net income from that country to the total net income from all sources; and then to limit the credit to an amount equal to the United States tax on such country's income. The result is that, if the income tax collected by foreign countries on such income has been imposed at rates which were equal to or less than the United States tax rates, the full amount of the foreign tax will be allowable as a credit; but if the foreign rates were higher than the United States tax rates, only that portion of the foreign tax will be allowed as a credit which is sufficient to offset the corresponding tax imposed in the United States. (See discussion in the House on the 1932 Revenue Bill, Cong. Rec. Vol. 75, pp. 6490, 6492-93.)

Under the revised method of computation which the respondent is attempting to use in the instant case, the credit would be limited, not merely to the extent necessary to prevent double taxation, but rather to a point where double taxation would exist despite the credit. There would not be included in net income from certain

foreign countries, the full amount of the foreign dividends upon which the foreign tax was imposed, but a reduced amount of dividend income remaining after deduction of an apportioned part of the taxpayer's expenses. It follows that the ratio of net income from such countries to total net income would be understated; and that full credit would not be given for the foreign tax paid on the dividends, even though the foreign tax rates were no higher than the United States tax rates. The effect would be double taxation.

The decisions below will affect practically every American concern doing business abroad. They run counter to the policy of Congress, as evidenced by the foreign tax credit provisions of the statute, to encourage business with foreign countries—a policy which can be expected to attain increased importance in the post war period. Moreover, if the expenses of a corporate taxpayer may be apportioned to dividends distributed to it by foreign corporations, it would appear that the door has been opened for a similar apportionment of expenses of individual taxpayers.

II.

The Circuit Court of Appeals has decided a Federal question in a way probably in conflict with applicable decisions of this Court.

The Treasury Regulations (Art. 131-3, *infra*, p. 19) have, as before stated, required for many years that every taxpayer claiming foreign tax credit shall attach to its income tax return a copy of the official form prescribed for that purpose (in the case of a corporation, Form 1118), and that it shall, under oath, supply "the

information there called for" and make "the calculations of credits there indicated". Because of these requirements and the fact that the calculations are necessarily complicated, taxpayers have regarded the treasury regulations and forms as guides upon which they might safely rely in computing their tax liabilities.

The respondent is now attempting to revise, retroactively, the method of calculation prescribed in these regulations and forms. He is attributing to the statute a meaning which, if it exists at all, is so obscure that the Treasury itself did not discover it until many years after the statute had been enacted and the rules for its application had been established.

This Court has recognized that such retroactive revisions should not be permitted. In *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), wherein an attempt was made to tax stock dividends retroactively, the Court said (pp. 402-3):

> "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability. * * * if he asked the tax collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. * * * To rip out of the past seven years of tax administration a principle of law on which both Government and taxpayers have acted would produce readjustments and litigation so extensive we would contemplate them with anxiety. We have recently held as to another questioned decision of this Court that a long period of accommodations to an older decision sometimes requires us to adhere to an unsatis-

> factory rule to avoid unfortunate practical results from a change. *Davis* v. *Department of Labor*, 317 U. S. 249. We think this another example of the same principle."

This Court also has held in several cases that the requirements of treasury regulations, long continued without substantial change, may not be revised retroactively after Congress has reenacted the statutes which they interpreted. In *Helvering* v. *Reynolds Co.*, 306 U. S. 110 (1939), it said (p. 116):

> "Since the legislative approval of existing regulations by reenactment of the statutory provision to which they appertain gives such regulations the force of law, we think that Congress did not intend to authorize the Treasury to repeal the rule of law that existed during the period for which the tax is imposed."

Similarly, in *Helvering* v. *Winmill*, 305 U. S. 79 (1938), the Court said (p. 83):

> "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law."

Conclusion.

It is respectfully submitted that the within petition should be granted.

International Standard Electric Corporation,
Petitioner,

By Allin H. Pierce,
Counsel for the Petitioner.

Dated: 111 West Monroe Street,
Chicago 3, Ill.,
December 9, 1944.

APPENDIX.

Statutes and Regulations Involved.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

[The material provisions of the Revenue Act of 1936 are identical, both as to section numbers and as to substance, with the corresponding provisions of the Revenue Act of 1938, hereinafter set forth.]

Revenue Act of 1938, c. 289, 52 Stat. 447:

Sec. 119. INCOME FROM SOURCES WITHIN UNITED STATES.

(a) *Gross Income from Sources in United States.*—The following items of gross income shall be treated as income from sources within the United States:

(1) *Interest.*—Interest from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including—

* * * * *

(2) *Dividends.*—The amount received as dividends—

(A) from a domestic corporation * * *

(B) from a foreign corporation * * *; but dividends from a foreign corporation shall, for the purposes of section 131 (relating to foreign tax credit), be treated as income from sources without the United States.

(3) *Personal Services.*—Compensation for labor or personal services performed in the United States, * * *

(4) *Rentals and Royalties.*—Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) *Sale of Real Property.*—Gains, profits, and income from the sale of real property located in the United States.

(6) *Sale of Personal Property.*—* * *

* * * * *

(c) *Gross Income from Sources without United States.*—The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in subsection (a)(1) of this section;

(2) Dividends other than those derived from sources within the United States as provided in subsection (a)(2) of this section;

(3) Compensation for labor or personal services performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the

use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties; and

(5) Gains, profits, and income from the sale of real property located without the United States.

(d) *Net Income from Sources without United States.*—From the items of gross income specified in subsection (c) of this section there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

(e) *Income from Sources Partly within and Partly without United States.*—Items of gross income, expenses, losses and deductions, other than those specified in subsections (a) and (c) of this section, shall be allocated or apportioned to sources within and without the United States, under rules and regulations prescribed by the Commissioner with the approval of the Secretary. * * *

* * * * *

Sec. 131. Taxes of Foreign Countries and Possessions of United States.

(a) *Allowance of Credit.*—If the taxpayer signifies in his return his desire to have the benefits of this section, the tax imposed by this title shall be credited with:

(1) *Citizen and Domestic Corporation.*—In the case of a citizen of the United States and of a

domestic corporation, the amount of any income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States;

* * * * *

(b) *Limit On Credit.*—The amount of the credit taken under this section shall be subject to each of the following limitations:

(1) The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources within such country bears to his entire net income for the same taxable year; and

(2) The total amount of the credit shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources without the United States bears to his entire net income for the same taxable year.

* * * * *

(c) *Proof of Credits.*—The credits provided in this section shall be allowed only if the taxpayer establishes to the satisfaction of the Commissioner (1) the total amount of income derived from sources without the United States, determined as provided in section 119, (2) the amount of income derived from each country, the tax paid or accrued to which is claimed as a credit under this section, such amount to be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary, and (3) all other information necessary for the verification and computation of such credits.

* * * * *

Treasury Regulations 94, relating to the Revenue Act of 1936:

[The material provisions of Regulations 94 are identical, both as to article numbers and as to substance, with the corresponding provisions of Regulations 101, hereinafter set forth.]

Treasury Regulations 101, relating to the Revenue Act of 1938:

Art. 131-2. MEANING OF TERMS.—* * * As to the meaning of "sources," see section 119.

Art. 131-3. CONDITIONS OF ALLOWANCE OF CREDIT.—If the taxpayer signifies in his return his desire to claim credit for income, war-profits, or excess-profits taxes paid other than to the United States, the income tax return must be accompanied by Form 1116 in the case of an individual, and by Form 1118 in the case of a corporation. The form must be carefully filled in with all the information there called for and with the calculations of credits there indicated, and must be duly signed and sworn to or affirmed. * * *

Art. 131-8. LIMITATIONS ON CREDIT FOR FOREIGN TAXES.

* * * * *

The operation of the limitations on the credit for foreign taxes may be illustrated by the following examples:

* * * * *

Example (3): The net income for the calendar year 1938 and the income and profits taxes paid or accrued to foreign countries and possessions of the

United States in the case of a domestic corporation were as follows:

Country	Net income	Loss	Income and profits taxes (paid or accrued)
United States	$200,000	—	—
Great Britain	30,000	—	$7,500
Canada	20,000	—	1,800
Brazil	40,000	—	2,400
Argentine Republic	60,000	—	None
Mexico	—	$100,000	None
Puerto Rico	10,000	—	1,250
France (dividend)	50,000	—	[1]9,000
France (branch)	20,000	—	3,000

[1] Withheld.

Entire net income	$330,000
Total foreign net income	130,000
United States tax before allowance of credit for foreign taxes	48,340

The income and losses from all foreign countries and possessions of the United States, except the dividend from sources within France, were derived from branch operations. Dividends of $50,000 were received from a French corporation, a majority of the voting stock of which was owned by the domestic corporation. The French corporation paid to France income and profits taxes on income earned by it and in addition a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source.

The computation of the credit is as follows:

* * * * *

France

Dividend tax paid at source	$ 9,000.00
Income and profits taxes paid or accrued on branch operations	3,000.00
Income and profits taxes deemed under section 131(f) to have been paid, * * *	7,324.24
Total income and profits taxes paid or accrued and deemed to have been paid to France	19,324.24
Limitation under section 131(b)(1) $\left(\frac{70,000}{330,000} \text{ of } \$48,340\right)$	10,253.94
Tentative credit	10,253.94

* * * * *

Form 1118—U. S. TREASURY DEPARTMENT—INTERNAL REVENUE SERVICE

STATEMENT IN SUPPORT OF CREDIT CLAIMED ON CORPORATION INCOME TAX RETURN FOR TAXES PAID OR ACCRUED TO A FOREIGN COUNTRY OR A POSSESSION OF THE UNITED STATES

To Be Filed by a Domestic Corporation

For Calendar Year 1938

* * * * *

Name of Corporation .....

Address .....

Claim for credit is made by the domestic corporation named above, on the attached corporation income tax return, * * * for taxes * * * as follows:

I. Total income from all sources * * * ..... $ .....

II. Total United States income tax on Item I ....

SCHEDULE A—Taxes Paid or Accrued During the Taxable Year to a Possession of the United States or a Foreign Country

Name of possession or foreign country imposing tax .....

1. Income[1] from sources in this possession or foreign country (exclusive of dividends received) * * * (reported in attached corporation income tax return on line .....) ..... $ .....

2. Dividends received from sources in this possession or foreign country * * * (reported in attached corporation income tax return on line .....) ....

3. Total income[1] from sources in this possession or foreign country (reported in attached corporation income tax return on line .....) $ .....

4. Amount of tax paid or accrued with respect to Item 1 * * * ..... $ .....

5. Amount of tax paid or accrued with respect to Item 2 by withholding at the source * * * ....

6. Amount of tax deemed to have been paid or accrued with respect to Item 2 * * * ....

7. Total of taxes paid or accrued (sum of Items 4, 5, and 6) ..... $ .....

8. Ratio of income[1] from sources in this possession or foreign country to total income[1] from all sources (Item 3 divided by Item I) $ .....

9. Amount of tax which may be claimed as credit under limitation of Section 131 (b) (1) (Item II, multiplied by Item 8, unless Item 7 is less than such amount in which case Item 7 should be entered here) ..... $ .....

* * * * *

[1] Form 1118 is reissued annually. In the forms issued for 1942 and subsequent years, the term "income" has been amended to read "net income".

AFFIDAVIT

We, the undersigned, president (or vice president, or other principal officer) and surer (or assistant treasurer, or chief accounting officer) of the corporation for h this statement is made, being severally duly sworn, each for himself deposes says that this statement has been examined by him and is to the best of his wledge and belief a true and complete statement of facts in connection with the it for taxes claimed on the attached corporation income tax return.

(JURAT)

.....
(President or other principal officer)

.....
(Treasurer, assistant treasurer, or chief accounting officer)

(13)

Nos. 739-740

In the Supreme Court of the United States

OCTOBER TERM, 1944

INTERNATIONAL STANDARD ELECTRIC CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Tax Court (R. 42–54) is reported in 1 T. C. 1153. The opinion of the Circuit Court of Appeals (R. 95–101) is reported in 144 F. 2d 487.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on September 9, 1944 (R. 102–105).[1] The petition for writs of certiorari was filed on

[1] This is the day that the "orders for mandate" issued (R. 102–105). The opinion of the court, affirming the orders of the Tax Court in part, and remanding the proceedings for recomputation of the tax because of the court's ruling as to

December 9, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, in determining "net income from sources without the United States" for purposes of the foreign tax credit limitation in Section 131 (b) of the Revenue Acts of 1936 and 1938, dividends from foreign corporations are to be subjected to deduction of a ratable part of such of the taxpayer's expenses as are not specifically allocable to any item or class of gross income.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in Appendix A, *infra*, pp. 11–18.

STATEMENT

The facts found by the Tax Court, so far as here pertinent, may be summarized as follows (R. 43–49):

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matters not here involved, was handed down on August 11, 1944 (R. 95–101). On the same day, the Clerk made the following docket entry with reference to these cases:

> August 11, 1944. Order modified, A. N. Hand, C. J. (The certificates of docket entries by the Clerk of the Circuit Court of Appeals for the Second Circuit have been lodged with the Clerk of this Court, and are printed in Appendix B, *infra*, pp. 19–20.)

Hence the question of the timeliness of the petition for a writ of certiorari which this Court is to consider in *Commissioner* v. *Bedford*, No. 710, this Term, is also involved in this case.

The taxpayer is an intermediate management and holding company in the International Telephone & Telegraph System. Most of the foreign sales and manufacturing units of the System were, in the tax years, subsidiary corporations owned by the taxpayer. With one exception, each of them was incorporated under the laws of the country in which it operates. None engages in business within the United States or has offices in this country. (R. 43–44.)

The taxpayer is not engaged in manufacturing, does not do business in any foreign country, and has no foreign branch or office. Under written contracts with its foreign subsidiaries, it provides management services, technical assistance, and patent, financial, and accounting information. In its New York offices, it employs experts, technicians, and clerks, who are informed about developments in the communications industry and correlate the work of the laboratories and the manufacturing and sales subsidiaries located abroad. Technical experts on the taxpayer's staff are loaned to subsidiaries at the latter's expense. For its managing services, the taxpayer charges its subsidiaries fees, usually computed on a percentage of sales basis, and it charges for patent privileges, royalties, and patent information. (R. 44.)

Gross income as shown on the taxpayer's income tax returns for 1937 and 1938 is as follows (R. 44–45):

	1937	1938
Gross profit from sales	$1,152,963.05	$1,082,320.62
Royalties	967,227.24	927,856.48
Contract revenue	381,343.23	507,550.24
Dividends from stocks of foreign corporations	3,764,682.81	5,609,585.47
Interest earned	290,427.64	364,624.96
Interest on obligations of the United States	425.00	425.00
Commissions	20,748.25	14,299.33
Capital gain or (loss)	83,589.61	(2,000.00)
Miscellaneous income	108,416.69	143,045.99
Profit realized on foreign exchange		95,501.91
Total	6,769,823.52	8,743,210.00

Deductions as shown on the taxpayer's income tax returns for 1937 and 1938 are as follows (R. 46):

	1937	1938
General and miscellaneous expense	$1,035,847.30	$1,025,177.97
Pension, sick and death benefits paid	122,964.58	80,488.30
Taxes, other than income taxes	79,148.93	77,523.02
Royalties, etc	861,300.27	930,848.19
Depreciation	2,803.46	1,052.46
Bad debts	557.19	10,946.54
Loss realized on foreign exchange	164,994.02	
Interest on funded debt		275,848.30
Interest on unfunded debt	337,745.34	404,732.85
Amortization of patents	588.17	1,448.92
Amortization of bond discount and expense		44,317.13
Total	2,606,009.26	2,852,383.68

The taxpayer's expenses were for the most part annually recurring operating expenses and the

amounts remained fairly constant from year to year except for minor variations such as salary adjustments. The amount of dividends from foreign subsidiaries varied, but the other gross income was fairly constant. R.47.)

The taxpayer has owned the shares of most of its subsidiaries for many years and does not buy and sell such shares (R. 47).

The amount of expenses is not related to the amount of dividends from foreign subsidiaries. Such dividends did not reflect earnings for the year in which paid. The taxpayer controlled the amount of dividends distributed to it by its subsidiaries. (R.47.)

Foreign taxes were withheld at the source, except in Sweden and Australia, where, pursuant to local law, the payors of the income filed returns on behalf of the taxpayer instead of withholding the tax (R. 47).

In determining the limitation upon the taxpayer's foreign tax credit under Section 131 (b) of the Revenue Acts of 1936 and 1938, the Commissioner determined the taxpayer's net income from sources without the United States by applying a part of the deductions, after adjustments irrelevant here, directly against gross income from within foreign countries, and a part directly against gross income from within the United States. The remainder of the deductions he treated as not directly allocable, and he applied

them ratably against gross income from within foreign countries and gross income from within the United States. (R. 46–47.)

The taxpayer maintained in the courts below (R. 51, 99) that of the deductions not directly allocable, no part should be applied against the dividends received by the taxpayer from foreign corporations.

The Tax Court rejected the taxpayer's contention (R. 49–52), and the Circuit Court of Appeals affirmed (R. 99–100).[2]

ARGUMENT

On the issue raised in the petition (pp. 8–9), the decisions below are correct and present no conflict.

Section 131 (b) of the Revenue Acts of 1936 and 1938 (Appendix A, *infra*, pp. 14–15), through the use of two fractions, limits the credit that may be taken by a taxpayer for taxes paid or accrued to foreign countries. In the second fraction the taxpayer's net income from sources without the United States is the numerator; the taxpayer's entire net income is the denominator. The credit for taxes paid or accrued to foreign countries may

[2] The opinions below also deal with the question, not pertinent here, whether deductions on account of certain royalty expenses paid by the taxpayer should be applied directly to certain items of income, or ratably to United States and foreign sources. On that issue, decided by the Tax Court in accordance with the Commissioner's contention there (R. 52–53), the Circuit Court of Appeals reversed (R. 100–101).

not exceed this fraction of the tax against which the credit is taken.

The taxpayer maintains that in arriving at the fraction, the dividends which it receives from foreign corporations are to be treated as an item of net income from without the United States, without any reduction on account of the taxpayer's expenses. If the fraction is so arrived at, the numerator is advantageously large for the taxpayer.

Under Section 131 (e) of the Revenue Acts of 1936 and 1938, credits for foreign taxes may be allowed only if the taxpayer establishes to the satisfaction of the Commissioner—[3]

> (1) the total amount of income derived from sources without the United States, determined as provided in section 119, * * *.

Under Section 119 (c) (Appendix A, *infra*, pp. 12–13) the following items of gross income are to be treated as income from without the United

[3] The taxpayer quotes a portion of clause (2) of Section 131 (e) and says that the decisions below make clause (2) redundant and ineffective (Pet. 6–7). If clause (2) is read in its entirety it will be seen to relate only to the method of determining what part of income from without the United States is derived from each foreign country. That allocation, necessary in computing the first fraction in Section 131 (b) (1), is left for regulations prescribed by the Commissioner, but the determination of the total amount of income from sources without the United States, necessary in computing the second fraction in Section 131 (b) (2), is governed by Section 119 (Appendix A, *infra*, pp. 11–14).

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States: (1) Interest other than from sources within the United States; (2) dividends other than those derived from within the United States; (3) compensation for labor or personal service performed without the United States; (4) gains, profits and income from the sale of real property located without the United States.

The method for determining net income from sources without the United States is prescribed by Section 119 (d). There are to be deducted from "the items of gross income specified in subsection (c)" the deductions properly apportioned or allocated thereto, "and a ratable part of any expenses * * * or other deductions which cannot definitely be allocated to some item or class of gross income."

The taxpayer does not assert that the deductions here in question can definitely be allocated to some item or class of gross income specified in subsection (c). Therefore, a ratable part must be deducted from all of the items of gross income there specified. "Dividends" is such an item. Hence dividends must bear their ratable share of general or non-identifiable expenses.

The taxpayer urges that the statute, thus read, is unfair in its application, inasmuch as the Tax Court found that the amount of expenses is unrelated to the amount of dividends from foreign subsidiaries (R. 47). Even though the two items are unrelated in amount, however, it is quite im-

possible to assume, as the taxpayer does, that none of the taxpayer's expenses are attributable to its receipt of the dividends; for example, the taxpayer incurs expenses for rent, accounting and clerical help (R. 50–51).[4] The statute is calculated to eliminate the difficult question of determining with precision what portion of such expenses should be ascribed to various sources of income.

The method of computation here used by the Commissioner comports with the plain meaning of the statute, and also with the text and example in Article 119–10 of Treasury Regulations 94 and 101 (Appendix A, *infra*, pp. 15–17). That Article, while it relates to the problem of determining net income from sources within the United States, plainly illustrates that under subsections (b) and (d) of Section 119, a ratable part of expenses which are not otherwise allocable must be allocated against gross income, including dividends. Example 3 in Article 131–8 of those Regulations Appendix A, *infra*, pp. 17–18, upon which the taxpayer relies (Pet. 3–4, note 1), is not concerned with the allocation of deductible losses and expenses to gross income—the problem here involved, and its bearing upon this problem, if any, is merely inferential.

[4] It should be noted that the court below held that where it was shown that expenses "bore no relation to the receipt of dividends," a ratable allocation should not be made (R. 101).

Because of the clear terms of the statute, the Circuit Court of Appeals found it impossible to sustain contentions of the taxpayer based upon some administrative practice in prior years and some indications in Treasury Form 1118 which seem to reflect a contrary interpretation of the statute. In rejecting the taxpayer's contentions in that regard, the decision below conforms to *Koshland* v. *Helvering,* 298 U. S. 441, and *American Chicle Co.* v. *United States,* 316 U. S. 450. Cf. *Eastman Kodak Co.* v. *United States,* 48 F. Supp. 357, 359 (C. Cls.).

CONCLUSION

The decisions below are correct and there is no conflict. The petition for writs of certiorari should be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
ROBERT KOERNER,
Special Assistants to the Attorney General.

JANUARY 1945.

APPENDIX A

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 119. INCOME FROM SOURCES WITHIN UNITED STATES.

(a) *Gross income from sources in United States.*—The following items of gross income shall be treated as income from sources within the United States:

(1) *Interest.*—Interest from the United States, any Territory, any political subdivision of a Territory, or the District of Columbia, and interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including—

* * * * *

(2) *Dividends.*—The amount received as dividends—

(A) from a domestic corporation * * *

(B) from a foreign corporation * * *; but dividends from a foreign corporation shall, for the purposes of section 131 (relating to foreign tax credit), be treated as income from sources without the United States;

(3) *Personal services.*—Compensation for labor or personal services performed in the United States, * * *

(4) *Rentals and royalties.*—Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property; and

(5) *Sale of real property.*—Gains, profits, and income from the sale of real property located in the United States.

(6) *Sale of personal property.*—For gains, profits, and income from the sale of personal property, see subsection (e).

(b) *Net income from sources in United States.*—From the items of gross income specified in subsection (a) of this section there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

(c) *Gross income from sources without United States.*—The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in subsection (a) (1) of this section;

(2) Dividends other than those derived from sources within the United States as provided in subsection (a) (2) of this section;

(3) Compensation for labor or personal services performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like properties; and

(5) Gains, profits, and income from the sale of real property located without the United States.

(d) *Net income from sources without United States.*—From the items of gross income specified in subsection (c) of this section there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

(e) *Income from sources partly within and partly without United States.*—Items of gross income, expenses, losses and deductions, other than those specified in subsections (a) and (c) of this section, shall be allocated or apportioned to sources within or without the United States, under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the ex-

penses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some items or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. * * *

* * * * *

SEC. 131. TAXES OF FOREIGN COUNTRIES AND POSSESSIONS OF UNITED STATES.

(a) *Allowance of credit.*—If the taxpayer signifies in his return his desire to have the benefits of this section, the tax imposed by this title shall be credited with:

(1) *Citizen and domestic corporation.*—In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war-profits, and excess-profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; * * *

(b) *Limit on credit.*—The amount of the credit taken under this section shall be subject to each of the following limitations:

(1) The amount of the credit in respect of the tax paid or accrued to any country shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources within such country bears to his entire net income for the same taxable year; and

(2) The total amount of the credit shall not exceed the same proportion of the tax against which such credit is taken, which the taxpayer's net income from sources

without the United States bears to his entire net income for the same taxable year.

* * * * *

(e) *Proof of credits.*—The credits provided in this section shall be allowed only if the taxpayer establishes to the satisfaction of the Commissioner (1) the total amount of income derived from sources without the United States, determined as provided in section 119, (2) the amount of income derived from each country, the tax paid or accrued to which is claimed as a credit under this section, such amount to be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary, and (3) all other information necessary for the verification and computation of such credits.

* * * * *

The pertinent provisions of the Revenue Act of 1936, c. 690, 49 Stat. 1648, are identical with the provisions of the Revenue Act of 1938 here set forth.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

ART. 119–10. *Apportionment of deductions.*—From the items specified in articles 119–1 to 119–6 as being derived specifically from sources within the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which can not definitely be allocated to some item or class of gross income. The remainder shall be included in full as net income from sources within the United States. The ratable part is based upon the ratio of gross

income from sources within the United States to the total gross income.

Example: A nonresident alien individual (engaged in trade or business within the United States or having an office or place of business therein) whose taxable year is the calendar year, derived gross income from all sources for 1938 of $180,000, including therein:

Interest on bonds of a domestic corporation	$9,000
Dividends on stock of a domestic corporation	4,000
Royalty for the use of patents within the United States	12,000
Gain from sale of real property located within the United States	11,000
Total	36,000

that is, one-fifth of the total gross income was from sources within the United States. The remainder of the gross income was from sources without the United States, determined under article 119–7.

The expenses of the taxpayer for the year amounted to $78,000. Of these expenses the amount of $8,000 is properly allocated to income from sources within the United States and the amount of $40,000 is properly allocated to income from sources without the United States.

The remainder of the expenses, $30,000, cannot be definitely allocated to any class of income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing net income from sources within the United States. Thus, there are deducted from the $36,000 of gross income from sources within the United States expenses amounting to $14,000 (representing $8,000 properly apportioned to the income from sources within the United States and $6,000,

a ratable part (one-fifth) of the expenses which could not be allocated to any item or class of gross income). The remainder, $22,000, is the net income from sources within the United States.

* * * * *

ART. 131–8. *Limitations on credit for foreign taxes.*— * * *

The operation of the limitations on the credit for foreign taxes may be illustrated by the following examples:

* * * * *

Example (3): The net income for the calendar year 1938 and the income and profits taxes paid or accrued to foreign countries and possessions of the United States in the case of a domestic corporation were as follows:

Country	Net income	Loss	Income and profits taxes (paid or accrued)
United States	$200,000		
Great Britain	30,000		$7,500
Canada	20,000		1,800
Brazil	40,000		2,400
Argentine Republic	60,000		None
Mexico		$100,000	None
Puerto Rico	10,000		1,250
France (dividend)	50,000		[1] 9,000
France (branch)	20,000		3,000

[1] Withheld.

Entire net income	$330,000
Total foreign net income	130,000
United States tax before allowance of credit for foreign taxes	48,340

The income and losses from all foreign countries and possessions of the United States, except the dividend from sources within France, were derived from branch operations. Dividends of $50,000 were received from a French corporation, a majority of the voting stock of which was owned by the domestic corporation. The

French corporation paid to France income and profits taxes on income earned by it and in addition a dividend tax for the account of its shareholders on income distributed to them, the latter tax being withheld and paid at the source.

The computation of the credit is as follows:

* * * * *

Dividend tax paid at source		$9,000.00
Income and profits taxes paid or accrued on branch operations		3,000.00
Income and profits taxes deemed under section 131 (f) to have been paid, computed as follows:		
Dividend received on December 31 of the taxable year	$50,000.00	
Income of French corporation earned during taxable year	200,000.00	
Income and profits taxes paid to France on $200,000	30,000.00	
Accumulated profits ($200,000 minus $30,000)	170,000.00	
French taxes applicable to accumulated profits distributed $\frac{50,000}{170,000}$ of $\frac{170,000}{200,000}$ of $30,000		7,500.00
Limitation under section 131 (f) $\frac{50,000}{330,000}$ of $48,340		7,324.24
Income and profits taxes deemed to have been paid (French taxes applicable to accumulated profits distributed to domestic corporation, reduced in accordance with the limitation under section 131 (f))		7,324.24
Total income and profits taxes paid or accrued and deemed to have been paid to France		19,324.24
Limitation under section 131 (b) (1) $\frac{70,000}{330,000}$ of $48,340		10,253.94
Tentative credit		10,253.94

* * * * *

The pertinent provisions of Treasury Regulations 94, promulgated under the Revenue Act of 1936, are identical with the provisions of Treasury Regulations 101 here set forth.

APPENDIX B

United States Circuit Court of Appeals
Second Circuit

C. C. A. Docket No. 19215

INTERNATIONAL STANDARD ELECTRIC CORP.,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT
(108866)

I, Alexander M. Bell, Clerk of the United States Circuit Court of Appeals for the Second Circuit, do hereby certify that the docket entries in the above entitled case in this Court are as follows:

February	23, 1944	Filed order of consolidation
March	6, 1944	Filed record
March	17, 1944	Filed stipulation re argument, et al
April	19, 1944	Filed 24 copies, record
April	19, 1944	Filed brief, petitioner
April	27, 1944	Filed appearance, Commr, by J. P. Wenchel, et al
May	26, 1944	Filed appearance, Commr, by S. O. Clark, Jr., et al
May	26, 1944	Filed brief, respondent
June	12, 1944	Filed brief, petitioner, reply
August	11, 1944	Order modified, A. N. Hand, C. J.
September	9, 1944	Filed order for mandate
September	9, 1944	Issued mandate
November	25, 1944	Certified record to A. H. P.
December	4, 1944	Filed order removing exhibits
December	16, 1944	Filed notice

Dated New York, January 11, 1945.

ALEXANDER M. BELL,
Clerk, United States Circuit Court of Appeals.

United States Circuit Court of Appeals
Second Circuit

C. C. A. Docket No. 19216

INTERNATIONAL STANDARD ELECTRIC CORP., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

I, Alexander M. Bell, Clerk of the United States Circuit Court of Appeals for the Second Circuit, do hereby certify that the docket entries in the above entitled case in this Court are as follows:

March	6, 1944	Filed record
August	11, 1944	Order modified, A. N. Hand, C. J.
September	9, 1944	Filed order for mandate
September	9, 1944	Issued mandate
November	25, 1944	Certified record to A. H. P. (See 19215)
December	16, 1944	Filed notice (See 19215)

Dated New York, January 11, 1945.

ALEXANDER M. BELL,
Clerk, United States Circuit Court of Appeals.

U. S. GOVERNMENT PRINTING OFFICE 1945